Nos. 11051 and 11059.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

SECURITY-FIRST NATIONAL BANK OF LOS ANGELES, a national banking association,

Appellant,

vs.

UNITED STATES OF AMERICA and H. F. METCALF, Trustee in Bankruptcy for the Estate of F. P. Newport Corporation, Ltd., a corporation, bankrupt.

Appellees.

UNITED STATES OF AMERICA,

Appellant,

vs.

H. F. METCALF, as Trustee in Bankruptcy of the Estate of F. P. Newport Corporation, Ltd., a corporation, bankrupt, and SECURITY FIRST NATIONAL BANK OF LOS ANGELES,

Appellees.

Upon Appeals from the District Court of the United States for the Southern District of California.

BRIEF FOR THE UNITED STATES.

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No. 11051

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No. 11059

UNITED STATES OF AMERICA,

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H. F. METCALF, as Trustee in Bankruptcy of the Estate of F. P. Newport Corporation, Ltd., a corporation, bankrupt, and SECURITY-FIRST NATIONAL BANK OF LOS ANGELES,

Appellees.

BRIEF FOR THE UNITED STATES.[1]

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[1]The above parties have stipulated, with the approval of this Court, that the United States may file one brief to cover both of these appeals. Prior to the stipulation, this Court ordered that these appeals be consolidated and that the record in No. 11051 be used not only in that case but also as a supplement to the record filed in No. 11059. [R. 68-69.] Accordingly, to prevent confusion, record citations herein will refer to the record in Case No. 11051, unless otherwise indicated.

PRIOR OPINIONS.

Case No. 11051.

The findings of fact, conclusions of law and order of the Referee in Bankruptcy appear in the record in this case at pp. 194-211.

The findings of fact, conclusions of law and order of the District Court [R. 343-358] are unreported.

Case No. 11059.

The order of the Referee in Bankruptcy appears in the record in this case at pp. 15-16. The findings of fact, conclusions of law and order of the District Court (No. 11059, R. 22-33) are unreported.

JURISDICTION.

On January 12, 1937, the F. P. Newport Corporation was adjudicated a bankrupt by order of the United States District Court for the Southern District of California acting under jurisdiction conferred by Section 2 of the Bankruptcy Act, as amended. Thereafter, on April 8, 1943, the District Court, in the same proceeding, and pursuant to the mandate[2] of this Court, allowed the claim of the United States in the sum of $19,363.65 for income taxes for 1938 and 1939. [R. 374-376.] Pursuant to the allowance of such claim, the United States Attorney filed a petition on behalf of the United States on September 24, 1943, for an order to show cause why H. F. Metcalf,

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[2]Mandate issued in *United States v. Metcalf,* 131 F. (2d) 677, certiorari denied, 318 U. S. 769.

Trustee in Bankruptcy for F. P. Newport Corporation, should not be directed to pay these taxes, the order to be directed to the Trustee and the Security-First National Bank of Los Angeles, as claimant of the available funds of the bankrupt estate. [R. 81-82.] Upon this order being issued [R. 194], answers thereto were filed by the bank on October 13, 1943 [R. 83-94], and by the Trustee in Bankruptcy on October 1, 1943 [R. 95-100]. After hearing, the Referee entered an order on June 6, 1944, directing payment of the above taxes. [R. 209-211.] Upon petition for review being duly filed by the Security-First National Bank of Los Angeles on July 14, 1944 [R. 214-228], the matter was heard by the District Court on November 27, 1944 [R. 343], and its order finding that the Referee did not err and directing payment of the taxes was entered February 6, 1945. [R. 358.]

Thereafter, on February 26, 1945, and within the time allowed by statute, the Security-First National Bank of Los Angeles filed notice of appeal to this Court [R. 359], pursuant to Section 24 of the Bankruptcy Act, as amended.

Case No. 11059.

Upon petition of the Trustee in Bankruptcy for authority to pay interest to the Security-First National Bank of Los Angeles out of the Trustee's special oil account and for order to show cause thereunder, hearing was held and the Referee entered an order on October 17, 1944, directing payment of such interest. [No. 11059, R. 15-16.] Petition for review of this order was filed on behalf of the

United States on November 14, 1944, and within the time allowed by statute. [No. 11059, R. 17-20.] The cause having come on for hearing, the District Court for the Southern District of California entered an order on March 6, 1945, and another on April 9, 1945, both of which affirmed the Referee's order, and directed payment of the interest; and judgment was entered on April 13, 1945. [No. 11059, R. 20, 33.] Thereafter notices of appeal to this Court were filed by the United States from these orders on May 2, 1945, which was within the time allowed by statute [No. 11059, R. 21, 34], and was pursuant to Section 24 of the Bankruptcy Act, as amended.

QUESTIONS PRESENTED.

1. In case No. 11051, whether income tax for 1938 and 1939, which this Court has already held to be due on oil and gas royalties received by the Trustee in Bankruptcy in those years, is payable out of such income as an administration expense under Section 64(a) of the Bankruptcy Act, as amended, in view of the fact that the property producing such income is subject to a deed of trust to secure a loan.

2. In case No. 11059, whether the District Court erred in directing payment of interest to the Security-First National Bank of Los Angeles, as an administration expense under Section 64(a) of the Bankruptcy Act, as amended, prior to payment of federal income taxes due for 1938 and subsequent years.

STATUTES AND REGULATIONS INVOLVED.

The applicable statutes and regulations are set out in the Appendix, *infra*, pages 1 to 3.

STATEMENT.

Case No. 11051.

The facts as found by the District Court may be summarized as follows:

About March 1, 1930, F. P. Newport Corporation, the bankrupt herein, borrowed $760,000 from the Security-First National Bank of Los Angeles (referred to hereinafter as the bank) and conveyed title to certain real property to the bank. At the same time the bank executed a written declaration of trust, now known as Trust D 7224, in which it acknowledged the conveyance of such property to it as trustee, taking such property not only as security for the above debt but for any further advances or costs incurred under the declaration of trust. [R. 344.]

Thereafter the F. P. Newport Corporation also conveyed other real property under this trust as additional security and record title to such property is now held by the bank. [R. 345.] Included in this real estate was a nine-acre tract of land for which the bank had advanced money in order to compromise the claims of various persons thereto. These advances were added to the debt owed the bank by order of the Bankruptcy Court. [R. 346.]

The declaration of Trust D 7224 provided for all proceeds from rents, leases and sales of the trust property to be paid to the Trustee (*i.e.*, the bank), which was to credit such income to a general fund, and to use it for paying costs, fees, taxes, assessments and installments on principal and interest. It was further provided that if the money available to the bank was insufficient to meet these needs, the beneficiary, by ratifying the trust would become liable for such sums. [R. 346-347.]

As the debt owed to the bank was overdue, it declared its intention to sell the property on March 29, 1935. But ten days before that date, an involuntary petition in bankruptcy was filed against the F. P. Newport Corporation, and soon thereafter H. F. Metcalf was appointed receiver of all the property, including the property to which the record title was held by the bank, as trustee. The bank was also restrained by the District Court from proceeding with the foreclosure sale. [R. 348.]

Thereafter, from time to time, up to January 12, 1937, the bank applied for leave to foreclose and sell certain real property which it held under its trust, but the court continued its restraining order. During this time extensive negotiations and conferences were held by the bank, the receiver and other interested parties looking for a method for liquidation of the property, record title to which was in the bank. These negotiations led to an agreement entered on January 12, 1937, by the bankrupt, the bank and the receiver. [R. 349.]

This agreement with subsequent modifications was approved and ratified by the District Court, and on appeal to this Court, the order of ratification was affirmed, and writ of certiorari to review such order was denied by the Supreme Court. [R. 350.]

The F. P. Newport Corporation was duly adjudicated a bankrupt on January 12, 1937, and on March 18, 1937, H. F. Metcalf was appointed trustee of the bankrupt estate. Since that time, he has been in possession of the assets of the bankrupt estate, and he has signed the agreement of January 12, 1937, and all supplements and modifications thereto upon order of the District Court. [R. 350.]

This agreement states that the debt due the bank amounted to $1,304,918.77 and should be paid in installments as provided therein, all to be paid by September 7, 1940. [R. 350-351.] The agreement, as modified, also provides [R. 351-352]:

> That while the said Declaration of Trust No. D 7224 and the contract of January 12, 1937, provide expressly that all moneys from sales and Leases of Property in said Trust shall be paid to and be received by the Bank, it is, nevertheless, agreed, in order to comply with the bankruptcy law requiring that all bankruptcy funds be accounted for by the Trustee and be disbursed by him only upon checks or warrants countersigned by the Referee, that all such moneys shall be paid to said Trustee in Bankruptcy, and, until the indebtedness due the Bank has been paid, shall be by him forthwith paid over in full to the Bank, to be distributed in accordance with the terms of said Trust No. D 7224 and the Agreement of January 12, 1937, as modified hereby.
>
> Recognizing that the Bank has a prior right to the moneys in the preceding paragraph mentioned until the indebtedness due it has been paid, it is therefore expressly understood and agreed that such funds or moneys so paid to and received by the said Trustee in Bankruptcy from Sales or Leases or other disposition of property under said Trust shall, until the indebtedness due the Bank has been paid and except as hereinafter provided, be, while in his possession impressed with the lien of the Declaration of Trust securing the indebtedness owing to the Bank, and such funds or moneys shall be deposited by the Trustee in Bankruptcy in a separate bank account and not commingled with any other funds of the Bankrupt Estate, and shall be deemed earmarked for

application on the Bank's indebtedness as provided in said agreement of January 12, 1937, and this supplement thereto, and except as in said agreement and said supplement provided, shall not, until the indebtedness due the Bank has been paid, become any part of the general assets of the Bankrupt Estate. No provision of said agreement of January 12, 1937, or this supplement thereto is made or entered into, directly or indirectly, for the purpose of fixing the amount of the fees or other compensation to be paid to any party in interest or any attorney of any party in interest in this bankruptcy proceeding, for services rendered in connection therewith or otherwise, and the fixing and determination of any fees or compensation to be paid to any one whomsoever from the assets of this Bankrupt Estate, is in accordance with the Law, left entirely to the determination of the court having jurisdiction of this bankruptcy proceeding, unaffected by any provision, term or condition, express or implied, of said contract of January 12, 1937, or of this supplement thereto.

Thereafter, with the approval of the District Court, the Trustee in Bankruptcy, the bankrupt and the bank, as trustee under its trust, made a lease with the Universal Consolidated Oil Company, as lessee, of a portion of the real property in the bankrupt estate, the record title to which stands in the bank's name. The purpose of such lease was to produce oil and gas and such articles have been produced in commercial paying quantities. [R. 352.]

The oil and gas royalties received by the Trustee in Bankruptcy from this lease have been deposited in a special account carried in his name at the bank's head

office. These royalties were paid out by the Trustee to the bank on orders of the District Court, and with the consent of the bank, for the purpose of covering taxes assessed against the properties, cost of engineering services for checking oil and gas production on the leased property and for principal and interest owed to the bank on the debt referred to above. [R. 353.]

On July 22, 1940, the United States Collector of Internal Revenue filed a claim in these proceedings on behalf of the United States for $19,363.65, representing the deficiency in income tax determined by the Commissioner of Internal Revenue as owing by the Trustee in Bankruptcy and the bankrupt corporation for 1938 and 1939. Objections filed by the Trustee in Bankruptcy were sustained by the District Court but, on appeal to this Court, were overruled, this Court holding that the Trustee and the bankrupt were indebted to the United States for income tax in the amount set forth in the claim. Pursuant to this Court's decision, the District Court signed an order in these proceedings on April 8, 1943, allowing the claim for income tax but no part of that claim has been paid. [R. 353-354.]

During 1938 and 1939, the bank here received $451,-851.01 from oil and gas royalties paid to it by the Trustee in Bankruptcy of which $289,271.47 was paid on the principal of the debt owed the bank, $97,665.88 was for interest on such debt, and the remainder for tax assessed against the property and for expense of checking production of oil and gas. [R. 354.]

The Commissioner of Internal Revenue determined that the net income in which the taxes here were assessed was $87,066.42 for 1938 and $30,288.99 for 1939. [R. 354.]

The Trustee in Bankruptcy does not have, and has not had, any funds with which to pay these income taxes unless the oil and gas royalties paid to him under the lease can be used for payment thereof. The bank claims the entire amount of such royalties must be paid to it without deduction. [R. 354.]

The agreement of January 12, 1937, provides in part as follows [R. 355-356]:

> Disbursement of the Special Fund. Out of the Special Fund, the Bank shall pay all taxes, assessments, insurance, interest and other charges and expenses of said Trust No. D 7224 not theretofore paid by the Trustee in Bankruptcy. After payment out of said Special Fund of all current interest, taxes, assessments and Trust Expense, and after first setting aside in said Special Fund a reserve sufficient to pay all interest, taxes, assessments and Trust Expenses for one additional year, the remainder of the money in said Special Account shall be paid over to the Trustee in Bankruptcy.
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> * * * * * * * * *
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> All income from oil, in the nature of bonuses, rentals and royalties from any of the properties held by the Bank in Trust, so paid to the Bank, shall be placed by the Bank in a Special Oil Account.
>
> The funds in said Account shall be available to the Trustee in Bankruptcy for the purpose of making up any deficiency in the "Special Fund," to pay interest, taxes, assessments, and expenses, as hereinabove pro-

vided, in order to obviate a default; provided, however, that all sums taken from said Oil Account for such purpose shall be repaid to said Oil Account from moneys thereafter coming into Special Fund and not needed to pay other or additional interest, taxes, assessments, or expenses then due.

Except as herein provided, all amounts in said accounts, shall be applied on September first and March first of each year, or on such other dates as shall be mutually agreed upon by the Trustee in Bankruptcy and the Bank, on the principal of said indebtedness and shall be considered as cash applied on the quotas of principal as hereinbefore set forth.

The Trustee in Bankruptcy had on deposit (when the District Court made its findings on February 6, 1945), in the special account carried in his name at the head office of the bank involved here, oil and gas royalties amounting to about $21,000. [R. 356.] The Trustee also had on deposit funds representing surface rentals amounting to $1,495.02. [R. 356.]

On the basis of these findings, the District Court reached the following conclusions [R. 356-358]:

1. The income tax for the calendar years 1938 and 1939 hereinbefore referred to was the result of the production of income the full benefit and enjoyment of which was had by the bank.

2. The properties, record title to which is held by the bank under its Trust D 7224 as security, have been administered by the Trustee in Bankruptcy by and with the consent of the bank and for its benefit.

3. These income taxes were incidental to the administration and a necessary part of the expense of operating, preserving, collecting and liquidating the properties and distributing the proceeds thereof.

4. The bank, having had the full benefit of the income which resulted in the assessment of the taxes, should pay the taxes out of that income for such taxes are a necessary cost of producing the income.

5. By the agreement of January 12, 1937, as supplemented and modified, the oil and gas royalties can be used to pay taxes including income taxes assessed against the Trustee in Bankruptcy and the bankrupt estate herein.

6. The claim of the United States for income taxes should be paid by the Trustee in Bankruptcy herein out of his special accounts and, if the funds now on deposit in these special accounts are insufficient to pay such taxes in full and interest thereon, such deficiency should be paid by the Trustee in Bankruptcy out of oil and gas royalties when and as received.

7. Since the funds then on deposit in the special accounts of the Trustee in Bankruptcy appeared to be insufficient to pay the income taxes in full and interest, it was not necessary to determine then whether oil and gas royalties paid to the Trustee in Bankruptcy herein, or surface rentals received by the Trustee, might be used to pay expenses of administration other than income taxes.

8. The Referee in Bankruptcy did not err in his order of June 6, 1944.

The District Court then ordered payment of the 1938 and 1939 income taxes due to the United States. [R. 358.]

Case No. 11059.

The facts stated above, to the extent that they are pertinent in this case, should be considered along with the following facts taken from the record in case No. 11059:

On September 7, 1944, there became due and payable, under the terms of the agreement of January 12, 1937, interest to the Security-First National Bank of Los Angeles in the sum of $5,534.11. [No. 11059, R. 30.]

On September 13, 1944, the Trustee in Bankruptcy herein filed a petition for authority to pay such interest to the bank out of the former's special oil account and for order to show cause thereunder. Such order being issued, hearing was held by the Referee who then ordered on October 17, 1944, that the Trustee in Bankruptcy was authorized and directed to pay interest to the bank out of the above fund in the sum set out. [No. 11059, R. 15-16, 30-31.]

Petition for review of the Referee's order by the District Court was filed on behalf of the United States on November 14, 1944 [No. 11059, R. 17-20], and after hearing, the District Court affirmed the Referee's order in orders filed March 6, 1945 [No. 11059, R. 20], and April 9, 1945 [No. 11059, R. 33].

At the time the Referee's order was made directing the payment of this interest there was on deposit in the special account the sum of $37,256.23, and at the time of the hearing of the petition on review by the District Court, there was on deposit in such account approximately $56,000. The Trustee is receiving on account of the oil

and gas royalties, and depositing in the special account, from $4,000 to $5,000 a month. [No. 11059, R. 31.]

In holding as indicated in the orders referred to above, the District Court concluded as a matter of law as follows [No. 11059, R. 31-32]:

1. The obligation of the Trustee in Bankruptcy to pay, out of the funds of this bankrupt estate, interest on the secured indebtedness of the Security-First National Bank of Los Angeles was one undertaken by and with the approval of the court and in order to secure time within which to liquidate the properties held under the trust of the bank and as part of the consideration to the bank to forego the right to immediate payment of its entire indebtedness; the obligation to pay the interest is a part of the cost of administering this estate.

2. Under the terms of the agreement of January 12, 1937, as supplemented and modified, payment of the interest may be made out of the funds in the Trustee's special account carried at the head office of the bank.

3. Failure to pay the interest when due would jeopardize this entire estate, for if, by reason of the failure to pay the interest, the court should grant leave to the bank to foreclose then this property would be lost to this estate.

4. The payment of the interest to the bank would not jeopardize or prejudice the United States, as there was on deposit in the special account more than sufficient funds to pay this interest and the allowed claims of the United States.

5. The payment of interest owing the bank was for the benefit of the estate and would benefit the United States of America in that it was necessary in order to preserve for the estate the property and the oil and gas income from the royalties.

Statement of Point to Be Urged by the United States.

The Referee in Bankruptcy erred in directing payment of $5,534.11 as interest to the Security-First National Bank of Los Angeles prior to payment of income taxes owed to the United States for 1938 and subsequent years.

Summary of Argument.

1. Upon a prior appeal, this Court held that the property of the bankrupt here was being operated by the Trustee in Bankruptcy and that the latter was liable for income tax on oil and gas royalties received under the lease of such property in 1938 and 1939. That decision constitutes the law in case No. 11051 and is a complete denial of the bank's contention that this income producing property was not a part of the bankrupt's estate. Thus the District Court correctly held that these income taxes were a part of the cost of administering the bankrupt's estate and are payable out of oil royalties.

It is well established that taxes which accrue, as did those here, during the pendency of bankruptcy proceedings are allowable under Section 64(a)(1) of the Bankruptcy Act, as amended, as part of the costs of administration, and are payable prior to claims of creditors, both secured and unsecured. It is also the general rule that such claims

may be paid in advance of the claims of valid lienholders who are entitled, under facts like those here, to recover only net profits from the operations of a trustee in bankruptcy. There is nothing in the agreement between the Trustee and the bank which precludes the application of the above rules here or which permits the latter to receive gross profits. Indeed, the agreement indicates that certain expenses are to be deducted therefrom prior to any payments on the bank's claim. Accordingly, we submit that the Government is entitled to payment of income taxes out of the oil royalties prior to payment of the bank's claim.

2. In case No. 11059, the District Court erred in approving payment of interest before payment of federal income taxes for 1938 and subsequent years. Interest is a debt just as the principal to which it accrues is a debt and should be so treated rather than as a cost of administration. The bank claims priority for its debt, and also interest thereon because of rights under a deed of trust which accrued prior to bankruptcy and under a subsequent agreement but the bank's claim cannot be given priority over a claim of the United States. This is not a case in which the payment of interest can be given precedence because of the doctrine of relation since that doctrine is not applicable to the Federal Government.

ARGUMENT.

I.

The Federal Income Taxes Due for 1938 and 1939 From the Trustee in Bankruptcy Because of His Operation of the Bankrupt Estate Are Payable as an Administration Expense Out of the Oil and Gas Royalties Received by Him in Those Years.

In Case No. 11051, the principal question relates to the fund available for the payment of federal income taxes amounting to $19,363.65,[3] and due from the Trustee in Bankruptcy for 1938 and 1939.

A. The Property Producing the Income on Which the Tax Was Imposed Was a Part of the Bankrupt's Estate.

The basis of the bank's objection to the payment of these income taxes out of the oil and gas royalties is that the property producing such income is not a part of the bankrupt's estate. In making this contention the bank relies on a prior deed of trust to which such property is subject and on the agreements which will be referred to in more detail below. This question is largely governed by a prior appeal (*United States v. Metcalf,* 131 F. (2d) 677, certiorari denied, 318 U. S. 769), in which this Court decided that the income taxes here involved were due. These taxes are corporate income taxes, and the basis of the decision on the prior appeal was, and necessarily so, that the Trustee in Bankruptcy was *operating*

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[3]Additional amounts are due for subsequent years. See No. 11059, R. 30.

the properties or business of the bankrupt. Of these properties, which this Court has already held were being operated by the Trustee, the bank now argues that 90 per cent were not a part of the bankrupt's estate. But the holding of this Court is a complete denial of that assertion.

There are no new facts in the instant case. Moreover all phases of the facts involved here were not only before this Court in the *Metcalf* case, *supra,* but were given careful consideration there. Thus the opinion in that case calls attention to these facts: (1) That 90 per cent of the assets of this bankrupt, consisting of several parcels of real estate, was encumbered by a trust agreement with the bank here; (2) that under a later agreement with the bank and, upon approval of the District Court sitting as a Bankruptcy Court, the Trustee in Bankruptcy was authorized to sell such property with proceeds going to the bank; (3) that inasmuch as oil wells were being drilled adjacent to two parcels of real estate, the Trustee in Bankruptcy and the bank feared oil and gas would be drained away from the bankrupt's property and so such property was leased by the Trustee with the approval of the Court for oil and gas operation; (4) that royalties received under this lease amounted to $245,517.65 in 1938 and to $20,133.36 in 1939; and (5) that the District Court had ordered these royalties paid to the bank to cover taxes assessed on these properties and also to pay costs of engineering services for inspection of oil and gas produced: and then to be applied on the debt owed to the bank. Upon these facts, the District Court decided that there was no income tax due because the Trustee was not

operating the property or business of the corporate bankrupt but this Court reversed that decision. In doing so, this Court pointed out that the leasing of the oil properties, the inspection of their operation and the collection of income therefrom constituted the carrying on of business of a corporate nature by the Trustee under order of the court, and within the provisions of Section 52(a) of the Revenue Act of 1938 (Appendix, *infra*). Accordingly this Court held that the Trustee in Bankruptcy was clearly operating the property of the bankrupt and so was liable for income tax on the oil and gas royalties received under the lease. Therefore the decision of this Court constitutes the law in the instant case.

In this connection it should also be noted that, even before the appeal just referred to, this Court ruled on the validity of the agreement between the bankrupt, the bank and the Trustee in Bankruptcy in 1937 and on the modifications thereto. See *In re F. P. Newport Corp.*, 98 F. (2d) 453. In sustaining the agreement, this Court held that the bankrupt estate, including the leased property which produced the income here was entirely within the jurisdiction and control of the District Court and that such court did not surrender its control by approving the agreement. Therefore this Court held, in substance, that the Trustee in Bankruptcy here was not acting, during the taxable years, merely as an agent of the bank but was the representative of all the creditors and proceeded, in operating the property of the bankrupt, under the direction of the District Court and with its approval.

We submit that this Court has previously not only fully considered the pertinent facts on this appeal but these decisions on the prior appeals preclude the holding here that the property producing the income on which the tax was imposed was not a part of the bankrupt's estate. This being so, it should certainly follow that such income is available for the payment of the income tax imposed thereon against the Trustee in Bankruptcy,[4] and that was the ruling of the District Court [R. 357-358] from which the bank appeals to this Court.

B. The Income Taxes Here Are Allowable as Costs of Administering the Bankrupt Estate and Are Payable Out of Oil Royalties Prior to the Claim of the Bank.

The District Court held [R. 357] that the income taxes here are a necessary cost in operating and administering the properties of the bankrupt. Thus such taxes are allowable under Section 64(a)(1) of the Bankruptcy Act, as amended (Appendix, *infra*), as part of "the costs and expenses of administration," which are given priority over claims covered by Section 64(a)(2), (3), (4) and (5), as well as all other claims of creditors, both secured and unsecured. From this it should be clear that in seeking to uphold the District Court's allowance of these taxes out of oil proceeds the Government is not asking that they be

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[4]The taxes which are sought here are corporate income taxes. Thus the Government has not attempted to collect from the bank, as trustee under the deed of trust. Of course if the bank were in fact the owner of the income-producing property, as it claims, it would be liable for income tax. But this Court has held that the Trustee is liable for the tax and such tax will be defeated entirely unless the Government can collect from the Trustee in Bankruptcy out of royalties, which constitute practically all of the money received by him.

allowed "as taxes"[5] under subdivision (4). While that subdivision refers to taxes, it covers only those which are legally due and owing by the bankrupt before the petition in bankruptcy is filed. But taxes which accrue during the pendency of the bankruptcy, or while a receiver or trustee is in charge, as did those here, are allowable as costs of administration under subdivision (1) and prior to payment of claims listed in subsequent paragraphs; and this is true whether the taxes are federal, state, county or city taxes. See *In re Lambertville Rubber Co.,* 111 F. (2d) 45 (C. C. A. 3d); *State of Missouri v. Earhart,* 111 F. (2d) 992 (C. C. A. 8th), certiorari denied, 311 U. S. 676; *United States v. Killoren,* 119 F. (2d) 364 (C. C. A. 8th), certiorari denied, 314 U. S. 640; *Northumberland Co. v. Philadelphia and Reading C. & I. Co.,* 131 F. (2d) 563 (C. C. A. 3d); *In re Burbank Corp.,* 48 F. Supp. 172 (S. D. Cal.); *Florida Nat. Bank of Jacksonville v. United States,* 87 F. (2d) 896 (C. C. A. 5th); and *In re Wil-Low Cafeterias,* 35 F. Supp. 965 (S. D. N. Y.). Also see *In re Humeston,* 83 F. (2d) 187, 189 (C. C. A. 2d).

Furthermore, it has been generally held that expenses, such as taxes or other charges which are connected with operation of the property of the bankrupt by a trustee in bankruptcy or are necessary to conduct its business, may be paid out of the income produced even though there is a claimant who has a lien on the property or the income

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[5]It should also be clear that the Government is not relying on Section 3466 of the Revised Statutes, to which counsel for the bank refers. Thus we think that *United States v. Waddill, Holland & Flinn,* 182 Va. 351, which is cited by counsel (Br. 46), has no application here but that case was reversed on January 2, 1945. See 323 U. S. 353. As to the distinction between Section 3466 and Section 64 of the Bankruptcy Act see *United States v. Emory,* 314 U. S. 423.

therefrom or both. *Adair v. Bank of America Assn.*, 303 U. S. 350, affirming 90 F. (2d) 750 (C. C. A. 9th); *Central Hanover B. & T. Co. v. Philadelphia & R. C. & I. Co.*, 99 F. (2d) 642 (C. C. A. 3d); *In re Preble Corp.*, 15 F. Supp. 775 (S. D. Me.); *In re Lasky*, 38 F. Supp. 24 (N. D. Ala.). In other words, the right of the lienholder or mortgagee does not attach to gross profits but to the profits remaining after the payment of administration expenses incurred in the business operated by the Trustee. See *Florida Nat. Bank of Jacksonville v. United States, supra.* In that case, foreclosure proceedings were stayed when reorganization proceedings in bankruptcy were instituted. Such stay was opposed by the mortgagee but the mortgaged hotel was taken over by a trustee in bankruptcy in 1935 and operated under court order. The trust agreement provided that, in the event that the property was so taken over by a trustee or receiver, the rents and profits from the property should be part of the mortgaged property and covered by the mortgage. Accordingly, it was argued there that the federal income tax, which accrued during 1935, the period that the trustee in bankruptcy operated the hotel, could not be paid out of the income produced by such operation. However, the court held that the income tax for such period was a cost of administration and was payable out of that income. Consequently only the net profits there were payable to the mortgagee.[6]

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[6]It is significant that while the court in *Florida Nat. Bank of Jacksonville, supra,* held that the 1935 income tax should be allowed as an administration expense, it refused to reach the same conclusion as to the 1934 tax which had accrued and was owing before the hotel was taken over by the trustee. As the 1934 tax could be allowed only as a tax claim, that case shows clearly the distinction between the two kinds of tax claims.

A similar conclusion was reached by this Court in *American Trust Co. v. English,* 84 F. (2d) 352 (cited in the bank's brief, pp. 26-27). There, a cattle ranch was taken over and operated by a trustee in bankruptcy for the bankrupt, a third mortgagee of such property, and the first mortgagee petitioned the referee for an order sequestering the proceeds from such operations. Pursuant to this petition, the trustee was directed to pay the ordinary and necessary expenses of maintaining the property and the taxes which had accrued, and then to pay the remainder of the income to the first mortgagee. Subsequently, as nothing was paid to the first mortgagee, the latter asked that the impounded funds be released but the District Court directed the trustee to pay such funds to another claimant. Then upon appeal, this Court ruled that the demand of the first mortgagee and the order of sequestration had been equivalent to possession by the latter and that it should recover the fund. However, it is significant that in so deciding, this Court held that the first mortgagee was entitled *to recover only the net proceeds* resulting from the trustee's operations of the ranch. Thus effect was given to the referee's original order that costs of administration, including taxes, should be paid first. To same effect see *Ingels v. Boteler,* 100 F. (2d) 915, 918 (C. C. A. 9th), affirmed, 308 U. S. 57.

We do not believe there is any essential conflict in the above cases and *In re Williams' Estate,* 156 F. (2d) 934 (C. C. A. 9th), on which counsel for the bank rely (Br. 11, 18), but if there is we submit that the later decisions of this and other courts should be controlling.

Counsel for the bank also rely on *In re Tresslar,* 20 F. (2d) 663 (M. D. Ala.), in which it was stated that the estate of a bankrupt consists of his property diminished

by valid liens. However, it should be noted it was also held there that the claims of the state, county and city (lienholders there) were payable only "after the payment of all costs of administration." (P. 665.) Thus, even in that case, it was decided, notwithstanding statements about the priority of such claims, that costs of administration can be paid out of funds claimed by valid lienholders and are payable prior to the allowance of the claims of such lienholders.[7]

C. There Is Nothing in the Agreement on Which the Bank Relies Which Prevents Payment of the Income Taxes Out of Oil Royalties Prior to Satisfaction of the Bank's Claims.

It seems too clear to require argument that the bank could not alter the terms of the Bankruptcy Act by agreement. But, even assuming for the sake of argument that the bank has so agreed, there is nothing in the agreement requiring that the bank be given more than net profits. That agreement was made by the bank, the bankrupt and the Trustee in Bankruptcy in 1937 and it provided, among other things, (1) that in order to enable such Trustee to pay taxes, assessments and other charges, he would be permitted to sell or lease certain parcels of the property [R. 107], and (2) that the Trustee was permitted to use rents and "profits from oil" up to a certain amount to pay taxes, expenses, assessments, etc. [R. 111]. In the first modification of that agreement, provisions were again

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[7]The above claims were for taxes which had accrued prior to bankruptcy and so would be allowable under Section 64(a)(4) of the Bankruptcy Act and not as an administration expense. But the *Tressler* case is of doubtful authority as it gives tax claims precedence over wage claims, and so fails to follow the order of priority prescribed in Section 64.

made permitting payment of taxes and all receipts were to go through the Trustee's hands. [R. 118-123.] Then in a later modification, the prior agreement was amended by entirely omitting the clause which had prohibited the use of any funds received by the Trustee in Bankruptcy from being charged with the expense of administering the bankrupt estate. [R. 128-130.] Thus, from these provisions, it is clear that even the agreement and the modifications thereto (which the bank was a party to and relies on so largely) do not give it anything but net proceeds and "taxes" were to be paid before any portion of the claim of the bank.

Furthermore, it appears that not only in framing the provisions of the agreement but in its actions generally, the bank has not objected to the deduction of various expenses from gross profits with one exception that it is not willing to have federal income taxes taken therefrom. Thus local taxes have been paid out of oil proceeds as have the engineering fees for inspecting the oil operations. Attorneys' fees in connection with litigation over title to the leased property were also paid out of such proceeds with the apparent consent of the bank [R. 130] and with the approval of this Court. See *Security-First Nat. Bank v. Bank of America, etc. Assn.,* 111 F. (2d) 50, in which the bank here contended that it was entitled to gross profits and that the District Court could not allow payment of the attorneys' fees out of oil royalties. However, this Court held that there was no merit in its contention and approved payment of the attorneys' fees out of the oil proceeds.

We submit that from the foregoing the Government is entitled to receive payment of income taxes out of oil royalties prior to payment of any claim of the bank.

II.

The District Court Erred in Approving the Referee's Order Directing Payment of Interest Upon a Debt of the Bankrupt Before Payment of Income Taxes Due the Federal Government.

In Case No. 11059, the sole question is whether the Referee properly directed the payment of interest (which became due on September 7, 1944) in the sum of $5,534.11 to the bank here on the debt owed by the bankrupt before payment of income taxes[8] due the Federal Government had been paid. It is the position of the Government that income tax which accrues during the pendency of a bankruptcy proceeding, as did the tax here, is allowable as an expense of administration but that the interest upon any debt owed by the bankrupt, even a secured one, is still only a debt or an accretion to a debt, and so is not entitled to priority under Section 64 (a) of the Bankruptcy Act over income tax. Moreover it is the general rule that after the property of an insolvent passes into the hands of the court, interest is not allowable against his estate for the delay in distribution is the act of the law and a necessary incident of the settlement of the estate. *State of Missouri v. Earhart*, 111 F. (2d) 992, 996 (C. C. A. 8th), certiorari denied, 311 U. S. 676.

The bank claims the right to payment of current interest because of its deed of trust and the subsequent agreement it made with the Trustee in Bankruptcy and the bankrupt

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[8]Such taxes for 1938 and subsequent years were estimated in April, 1945, as amounting to $65,000. The taxes for 1938 and 1939 have been allowed and amount to $19,363.65. [No. 11059, R. 82.] But those for subsequent years have not yet been allowed as far as we know. Apparently the Trustee is withholding action on such taxes pending outcome of the appeals in those cases.

in 1937. Under such circumstances, current interest is sometimes allowable to private individuals. That is because of the doctrine of relation but such doctrine is not applicable in cases where the United States is the contesting claimant. *New York v. Maclay,* 288 U. S. 290. Therefore the bank's claim for interest was improperly allowed.

Conclusion.

The decision of the District Court in No. 11051 is correct and should be affirmed, but the decision in No. 11059 is erroneous and should be reversed.

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APPENDIX.

Bankruptcy Act of 1898, c. 541, 30 Stat. 544:

SEC. 64 [as amended by the Act of June 22, 1938, c. 575, 52 Stat. 840]. *Debts Which Have Priority.* —a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the actual and necessary expenses of preserving the estate subsequent to filing the petition; the filing fees paid by creditors in involuntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, shall have been recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of such recovery, the costs and expenses of administration, including the trustee's expenses in opposing the bankrupt's discharge, the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the petitioning creditors in involuntary cases and to the bankrupt in voluntary and involuntary cases, as the court may allow; (2) wages, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; (3) where the confirmation of an arrangement or wage-earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost

and expense of one or more creditors, or where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under this Act, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof: *Provided,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court: *And provided further,* That in case any question arises as to the amount or legality of any taxes, such question shall be heard and determined by the court; and (5) debts owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupany of the premises affected, and which accrued within three months before the date of bankruptcy.

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(11 U. S. C. 1940 ed., Sec. 104.)

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 52. CORPORATION RETURNS.

* * * In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in

the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

Art. 52-2. *Returns by receivers.*—Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations. If a receiver has full custody of and control over the business or property of a corporation, he shall be deemed to be operating such business or property within the meaning of section 52, whether he is engaged in carrying on the business for which the corporation was organized or only in marshaling, selling, and disposing of its assets for the purposes of liquidation. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee, or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control. * * *